No. 12259

In The United States Court of Appeals
For the Ninth Circuit

SEATTLE HARDWARE COMPANY, *Appellant,*

vs.

CLARK SQUIRE, Collector of Internal Revenue,
Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

OPENING BRIEF FOR APPELLANT

FILED

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OPINION BELOW

The Opinion of the District Court is Reported in 83 Federal Supplement 106; 49-1 U.S.T.C. Par. 9155.

JURISDICTION

This is an appeal from a judgment entered April 11, 1949, by the District Court for the Western District of Washington, Southern Division, dismissing appellant's complaint. Appellant sought recovery from the appellee, as Collector of Internal Revenue, on claims for refund of income and excess profits taxes in the amount of $202,681.10 plus interest, for the fiscal years ending November 30, 1941 to 1945 inclusive, which taxes had been assessed against and paid by appellant to appellee (R. 36-41). The action arose under Section 24(5) of the Judicial Code, as

amended, and as qualified by Section 3722 of the Internal Revenue Code, as amended, jurisdiction having been vested in the United States District Court thereunder. The case is brought to this Court by notice of appeal filed May 9, 1949 (R. 224-225). The jurisdiction of this Court is invoked by virtue of the provisions of Title 28, United States Code, Section 1294 as amended.

STATEMENT OF THE CASE

This case involves appellant's income and excess profits tax as above stated. However, appellant's claim for 1942 was not filed within the period of limitation now held to be controlling and the parties have stipulated that it is to be eliminated from consideration. The issue of this case briefly stated is as follows: The Seattle Hardware Company in 1901 contemplated the purchase of Lots 1 and 2, Block 327, Seattle Tide Lands, for use as a plant building site. A subsidiary corporation, the Occident Trust Company, was organized to take title to the land and construct the building in its own name. The subsidiary was used to limit the liability of the parent on the construction. After the building was completed, the land and building were transferred to the parent and the subsidiary was dissolved. All these transactions took place prior to the adoption of the Sixteenth Amendment. The appellant's position is that the separate identity of the Occident Trust Company should be respected and that its basis in the land and building for gain or loss and invested capitol purposes is their fair market value at the time the subsidiary was liquidated, February 21, 1906. The

appellee's position is that the separate identity of the subsidiary should be ignored and that the appellant's cost is the actual cost to the subsidiary.

STATEMENT OF FACTS

The facts, briefly stated, are as follows:

Seattle Hardware Company was organized as a corporation under the laws of the Territory and later State of Washington in 1885 and has ever since carried on a wholesale hardware business in the City of Seattle (R. 36). On April 15, 1901, there was organized a Washington corporation called the Occident Trust Company, with a capitalization of $100,000.00, consisting of 1,000 shares of capital stock of the par value of $100.00 each (Pl. Ex. 5). The incorporators of Occident Trust Company were Ira Bronson, who was attorney for Seattle Hardware Company, and two other individuals who were not connected with it (R. 58).

On April 15, 1901, Ira Bronson subscribed for the entire capital stock of the Occident Trust Company, and offered to convey Lots 1 and 2, Block 327, Seattle Tide Lands, to that corporation in full payment of the subscription. By unanimous vote a resolution was adopted by the trustees of the Occident Trust Company stating in part "Whereas said property is of a value of upwards of $100,000.00 now, therefore, be it resolved that this Company accept the offer of said Ira Bronson * * *." The minutes of the meeting in which the above resolution was recorded went on to state that Ira Bronson then delivered to the company a deed of said property,

properly executed, and the President and Secretary "then and there issued and delivered to the said Bronson all the capital stock of this company." Thereupon Ira Bronson, Dana Brown and Lawrence L. Moore, the original incorporators, resigned, and M. D. Ballard, C. H. Black and F. W. Baker were duly elected to fill the vacancies caused by the resignations, and they assumed the duties of their office after subscribing the proper oath of office (Pl. Ex. 5). The latter three men were trustees and stockholders of the appellant corporation at the time they were elected trustees of the Occident Trust Company (R. 51).

Lots 1 and 2, Block 327, Seattle Tide Lands, were acquired by Ira Bronson from Stetson & Post Mill Company by deed dated April 19, 1901, for a recited consideration of $60,000.00 (Pl. Ex. 4). Ira Bronson and his wife conveyed the property to the Occident Trust Company by a deed dated October 1, 1903 (Pl. Ex. 4).

The stock records of the Occident Trust Company could not be located (R. 52) so that the exact manner of issuance of its stock is not definitely shown, but the minutes of a special meeting of the Board of Trustees of the Seattle Hardware Company, dated September 20, 1905, show that at that time Seattle Hardware Company owned all the stock of the Occident Trust Company (Pl. Ex. 2). Seattle Hardware Company carried the stock of the Occident Trust Company on its books at that time at a value of $120,000.00 (R. 168).

Lots 1 and 2, Block 327, which constituted the sole

asset of Occident Trust Company (R. 53) were occupied by some old buildings which required frequent repairs and produced a small amount of revenue, and the records of such transactions and the accounts of Occident were kept by the Seattle Hardware Company on an account set up on its books, the first entries of which were dated in April of 1901 (Pl. Ex. 8).

In 1904 Occident Trust Company began the construction of a seven-story and basement brick mill type building which was completed early in 1905 (R. 136) at a total cost of $244,000.00 (R. 43). All of the building costs were handled through the Occident Trust Company account on the books of Seattle Hardware Company (Pl. Ex. 8 and 9) (R. 163 to 170).

On February 14, 1906, the Seattle Hardware Company appreciated its investment in Occident Trust Company stock by $100,000.00 (R. 55) crediting that amount to surplus (Pl. Ex. 9). Shortly thereafter it, as the owner of all the stock of Occident Trust Company, decided to liquidate that company by taking over all of its assets (R. 55) and pursuant thereto, on February 21, 1906, it received a conveyance of title to Lots 1 and 2, Block 327, Seattle Tide Lands (Pl. Ex. 1), and transferred the book value of the stock and its account against the company to its real estate account (Pl. Ex. 9). The Occident Trust Company was thereupon left without any assets (R. 53), did no further business (R. 56), and paid no further license fees, and after three years its name was stricken from corporate rolls by the Secretary of State (Pl. Ex. 7).

On the books of the Seattle Hardware Company, after the liquidation of the Occident Trust Company, the land was recorded at the figure of $220,000.00 and the buildings at the figure of $244,000.00 (Pl. Ex. 9), and these amounts with proper additions and depreciation with respect to the building were thereafter used in computing equity invested capital in Seattle Hardware's income and excess profits return for 1941 (R. 43).

The return was audited by the Commissioner of Internal Revenue, resulting in an additional assessment of $26,220.07, being assessed against Seattle Hardware Company, based on reducing equity invested capital for land account from $220,000.00 to $60,000.00, thereby eliminating the land appreciation that had been set up when the Occident Trust Company owned Lots (1) and (2) (R. 43). The ultimate taxes determined and paid for 1941, 1942, 1943, 1944 and 1945 were on the basis of a reduction in equity invested capital for Lots (1) and (2) to $60,000.00 (R. 43).

In 1945, Seattle Hardware Company sold the land and buildings and as a basis for computing gain or loss, used a $60,000 cost of Lots (1) and (2) and a $244,000 cost of the building before taking into consideration additions to and depreciation of the building (R. 43).

On April 5, 1946, the Seattle Hardware Company filed claims for refund of income and excess profits taxes for the years 1941 through 1945, alleging that its cost basis in Lots (1) and (2) and the building before additions to and depreciation of the building

was the fair market value of the stock of the Occident Trust Company surrendered in liquidation when the land and building were transferred to it, that fair market value in turn being measured by the fair market value of the assets transferred (R. 44).

In the claims for refund appellant used a fair market value for the land of $224,322.00 and a fair market value for the building of $297,502.77 on February 21, 1906 (R. 44). The parties have stipulated that the fair market value of the land was $224,322.00 and the buildings $270,751.38 on February 21, 1906, the date the property was deeded by the Occident Trust Company to the Seattle Hardware Company (R. 44).

QUESTIONS PRESENTED

The contentions of the parties in this case are set forth in the Pre-Trial Order (R. 30-34). Briefly stated they are as follows:

The appellant contends that for purposes of determining invested capital credit in computing excess profits taxes for the fiscal years ended November 30, 1941, through November 30, 1945, and for purposes of determining gain or loss on the sale of the property in 1945 it is entitled to a cost basis for Lots (1) and (2) of $224,322.00 and a cost basis for improvements of $270,751.38 (before adjustments, additions and depreciation) that being the stipulated value of the assets of its subsidiary, the Occident Trust Company, on February 21, 1906, the date the subsidiary was liquidated by a transfer of all its assets to the parent.

The appellee contends that the separate identity of the subsidiary, Occident Trust Company, should be disregarded and that the cost basis of the subsidiary of $60,000 for the land and $244,000 for the improvements should carry over as the cost basis of the parent.

In deciding the case for the appellee, the District Court held that the Occident Trust Company was never more than a nominal holder of the property; that it was not a corporate structure acting in any sense as an independent entity; that it had an incomplete existence as a corporate structure because of the Court's determination that no stock had been issued, and that appellant was at all times the owner of the property following its acquisition by Ira Bronson in April 1901.

STATUTES

(Includes only statutes referred to but not quoted in the text)

Section 113(a) (14) I.R.C.

> "(14) Property Acquired Before March 1, 1913.—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date."

Section 113(a) (6) I.R.C.

"(6) TAX-FREE EXCHANGES GENERALLY.—If the property was acquired after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, or section 112 (1), the basis (except as provided in paragraphs (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consists in part of the type of property permitted by section 112 (b) or section 112 (1) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. Where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for the purposes of this paragraph, be considered as money received by the taxpayer upon the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."

Section 113(a) (15) I.R.C.

> "(15) Property Received by a Corporation on Complete Liquidation of Another.—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor. The basis of property with respect to which election has been made in pursuance of the last sentence of section 113 (a) (15) of the Revenue Act of 1936, as amended, shall, in the hands of the corporation making such election, be the basis prescribed in the Revenue Act of 1934, as amended."

STATEMENT OF POINTS TO BE URGED

The appellant is entitled to a cost basis for Lots (1) and (2) of $224,322.00, and for improvements thereon of $270,751.38, subject to adjustments, additions and depreciation, and such cost basis controls for gain or loss and invested capital purposes, and appellant's claims for refund for all years here involved, except the fiscal year ending November 30, 1942, should be allowed to that extent.

ARGUMENT

I. The Question of Separate Entity.

A. Was the organization of Occident Trust Company Complete?

The District Court erred in determining that the Occident Trust Company had an incomplete existence because no stock was issued (R. 215, 216).

In the first place, the evidence was sufficient to establish that stock was issued. The minutes of the meetings of the trustees of the Occident Trust Company state that stock was issued and held by Seattle Hardware Company (Pl. Ex. 2). Mr. Wills, who was a trustee of Seattle Hardware Company beginning in 1905 (R. 119) testified he positively recalled seeing the stock (R. 120) and testified that while the stock was issued in the names of various stockholders of the Seattle Hardware Company (R. 120) it was beneficially owned by the Seattle Hardware Company (R. 120).

But in any event, the organization of the Occident Trust Company was complete regardless of the issuance or non-issuance of capital stock. It is rather obvious in this case that while Ira Bronson purchased Lots (1) and (2), organized the Occident Trust Company, and turned the lots in to the company for the capital stock of the company, he was acting as agent of the Seattle Hardware Company, and the Seattle Hardware Company initially furnished the $60,000.00 purchase price for the lots. The District Court so found (R. 186).

The minute book of the Occident Trust Company (Pl. Ex. 5) shows that its articles were filed, trustees were elected, and qualified, by-laws were adopted, the entire capital stock was subscribed, paid for, and allotted. The general corporation laws in effect at the time the Occident Trust Company was organized in 1901 were those contained in Chapter 185 of the Code of Washington, adopted in 1881 (Code of Wash-

ington 1881, page 416). Section 2424 of that Code provided that "when the certificate of incorporation" was "filed the persons who have signed the certificate" of incorporation and their successors "shall be a body corporate and politic in fact and in name, by the name stated in their certificate * * *." Chapter 116 of the Washington Session Laws of 1891 amended the above Code to provide "that no such corporation shall commence business * * * until the whole amount of its capital stock has been subscribed." The Occident Trust Company was a complete corporation under Washington law, regardless of whether stock certificates were actually issued.

Section 5094 of Chapter 58 of Fletcher's Cyclopedia of the Law of Private Corporations, Volume 11, page 64, indicates "that a certificate of stock is not the stock itself, but merely the written evidence of the stockholder's rights as such. It is a necessary conclusion therefrom that issuance of a certificate of stock is not necessary to make one a stockholder. And it is well settled, as a general rule of corporation law that, in the absence of statutory or charter provision or agreement to the contrary, a subscriber for stock in a corporation, * * * becomes a stockholder as soon as his subscription is accepted by the corporation, and statutory or charter conditions are performed or fulfilled, or as soon as the purchase is completed, as the case may be, whether a certificate of stock is issued to him or not; and, although he may have no certificate, he is thereupon entitled to all the rights."

It follows that even if no stock certificates were issued, since Ira Bronson was agent of the Seattle

Hardware Company, as the District Court determined (R. 186) the Seattle Hardware Company became the sole stockholder of the Occident Trust Company and properly operated the Occident Trust Company through trustees who were likewise officers and trustees of the Seattle Hardware Company.

B. Should the separate identity of Occident Trust Company be respected?

The District Court erred in holding that the Occident Trust Company was not a corporate structure acting in any sense as an independent entity; and that it never was more than an instrumentality created by taxpayer temporarily to hold title for taxpayer, and nothing more. This issue of when a subsidiary's separate identity will be respected or disregarded, has a wealth of case law to resolve it, especially tax cases, which establish that if the subsidiary is formed and operated for business purposes, its separate identity will be recognized even though it has substantial identity, in practical operation, with its parent. If a subsidiary is simply a sham or acting merely as an agent for its stockholders without a business purpose or for tax avoidance, its separate identity will be disregarded.

Of course there is no tax avoidance involved here as the entire transaction took place seven years prior to the time the income tax law was adopted.

What does the evidence show as to the reason for organizing the Occident Trust Company, transferring the property to it, having it construct the building, and not taking the property into the Seattle

Hardware Company until February 21, 1906? The evidence is as follows: Mr. Ira Bronson purchased the lots from Stetson & Post Mill Company on April 19th of 1901. The consideration was $60,000. While probably the Seattle Hardware Company had furnished the $60,000, for the sake of accuracy, it should be pointed out there is no direct evidence that such was the case.

Even if Seattle Hardware Company did advance the money for the purchase of the lots, at the time of the purchase it did not have and did not want to take legal title in its own name. On the contrary, it deliberately planned to avoid the responsibility of ownership. Occident Trust Company was organized prior to the acquisition of the lots by Ira Bronson (Pl. Ex. 5) and transfer of title ran directly from Stetson & Post Mill Company to Ira Bronson (Pl. Ex. 4).

Ira Bronson subscribed for all of the stock of the Occident Trust Company and offered to convey the legal title to Lots (1) and (2) to the Occident Trust Company in satisfaction of his subscription (Pl. Ex. 5). Acceptance of the offer was authorized by the Board of Directors of the Occident Trust Company (Pl. Ex. 5). While legal title was not actually transferred from Ira Bronson to the Occident Trust Company until October 1, 1903 (Pl. Ex. 4), it is clear that Occident Trust Company was the real owner of the property from and after its acceptance of his offer. The Seattle Hardware Company never had legal title to the lots until they were transferred to it by the Occident Trust Company on February 21, 1906 (Pl. Ex. 1).

The evidence is positive that the ownership of the lots and the construction of the building were deliberately divorced from the Seattle Hardware Company for business reasons. Mr. Ballard testified on direct examination (R. 50 and 51):

> "Q. What was the occasion for forming that company? (Refering to the Occident Trust Company.)
>
> A. We formed that company to act as a holding company, real estate holding company, in order that we might not have to spoil the looks of our financial statement by the borrowing that it would be necessary to do in buying the property and building the building.
>
> Q. Do you recall whether there were any other reasons for forming the company besides what you have just mentioned?
>
> A. Not that I know of.
>
> Q. Was there any discussion or consideration of the matter of risk of liability for claims in connection with building construction?
>
> A. Claims against the company, you mean?
>
> Q. That might arise in connection with construction.
>
> A. Well, that again was just considered the same thing; in other words, we protected the Seattle Hardware Company as a hardware store against undue financial risk."

In his redirect examination he testified (R. 68 and 69):

> "Q. You said in answer to Mr. Miller's question that in fact, the holding of the property was to be merely temporary and that it was to be trans-

ferred back to the Seattle Hardware Company at some time. What I would like to know is what specific discussion or consideration can you now recall on that subject?

A. None, other than the fact that that was a land company or real estate holding company, and, as I said before, was not to be confused in any way with the operation of the Seattle Hardware Company. The Seattle Hardware Company was incorporated as a hardware store, and as soon as it took title to the property and there was no longer any confusion as to construction or real estate matters, then the Occident Trust Company would cease to function and the Seattle Hardware Company would carry on."

The testimony of Mr. Charles S. Wills was to the same effect. In his direct examination he testified (R. 123 and 124):

"Q. What had been the purpose or function of the Occident Trust Company?

A. To build this building on the land that they had acquired, and to make the contracts in the name of the Occident Trust Company, and do all those things that would avoid the responsibility or legal liability of the parent company.

Q. And what were the reasons why they—well, I guess you have stated the reasons why it was a separate company.

A. One other reason was, they had—had to borrow money, and that was an obligation of the Occident Trust Company, and it relieved the Se-

attle Hardware Company from that much bills payable.

Q. Were you with the company at the time that that mortgage was given, do you recall?

A. Well, that I can't recall, but I do recall many times going to the Thomas Investment Company to make an installment of interest.

Q. This will be shown in evidence a little later, that under date of September 21st, 1905, the Occident Trust Company issued a mortgage to Travelers' Insurance Company for a hundred fifty thousand dollars. Were you with the Seattle — —

A. I was.

Q. Is this one of the circumstances that you refer to, is it?

A. Yes."

On cross-examination Mr. Wills further testified (R. 136):

"A. Well, the Seattle Hardware Company was a trading concern, engaged in merchandising, and this was another venture, building a building, and it involved considerable liabilities and responsibilities and they thought the best way to—to overcome that was to have a separate corporation to do the work, to complete it, and to borrow money for its completion.

Q. Borrow it in the name of this separate corporation?

A. Occident—yes, Occident Trust Company."

And later (R. 141):

"Q. Well, then, the only activities that you

> know of that the Occident Company performed, it held the title to this property and during the time that the building was constructed.
>
> A. They not only owned—held the title, they owned the property and they built the building and borrowed the money to complete the building."

The evidence shows that during the course of construction of the building, the identity of Occident Trust Company as owner was carefully preserved. The contractor's bond of Donaldson Bros. ran to the Occident Trust Company; the contractor's bond of H. W. Hawley ran to the Occident Trust Company; the contractor's bond of Ernest Carstens ran to the Occident Trust Company; the contractor's bond of Soderberg and Hill ran to the Occident Trust Company. Invoices of H. W. Hawley, F. M. McLellan, T. E. Jones, Washington Steam Heating Co., D. E. Fryer & Company, Washington Iron Works Co., George W. Church, Soderberg & Hill and Index Granite Works all ran to the Occident Trust Company (Pl. Ex. 3). Invoices of Pacific Wire & Plating Works and Z. C. Miles & Piper Co. ran to the Seattle Hardware Company, but these were changed by A. Wickersham, Architect, to the Occident Trust Company (R. 143).

It is clear that the Occident Trust Company was formed and used for a business purpose, and engaged in business activity on its own account. It was formed and proceeded to take title to the real estate and construct a building on it, for the perfectly legitimate purpose of relieving Seattle Hardware Company of

liability and responsibility on financing and construction risks. The situation calls for recognition of the separate entity under the applicable decisions.

Brief reference will be made to Washington state and Ninth Circuit decisions where disregard of separate corporate identity in other than tax cases is discussed, but the main authorities will be tax decisions.

To the extent that the matter is governed by State Law, under *Erie Railroad Co. v. Tomkins*, 304 U.S. 64, 82 L. ed. 1188, 58 S. Ct. 817, it is fully disposed of by *Pittsburgh Reflector Company v. Dwyer & Rhodes Co., Inc.*, 173 Wash. 552, where the general rule is set forth as follows (pp. 554, 555):

> "Mere common ownership of the capital stock, interlocking directorates, or like evidences of close association, will not justify the courts in disregarding corporate identities. *Associated Oil Co. v. Sieberling Rubber Co.*, 172 Wash. 204, 19 P.(2d) 940, and cases there cited.
>
> "In order to justify the judicial disregard of corporate identities, one, at least, of two things must clearly appear. Either the dominant corporation must control and use the other as a mere tool or instrument in carrying out its own plans and purposes so that justice requires that it be held liable for the results, or there must be such a confusion of identities and acts as to work a fraud upon third persons. In most, if not all, of the Washington decisions in which corporate entities have been diregarded, both elements have appeared, and there is strong authority for the rule that both elements (if there be

> two) must appear to warrant relief." (Citing cases)

Similar pronouncements outside of the tax field have been made by the Court of Appeals for this Ninth Circuit, of which we refer only to the following as typical:

Exchange National Bank of Spokane v. Meikle, 61 F.(2d) 176, involved a suit by a trustee in bankruptcy to recover a preference, which turned upon the construction to be placed upon the financial relationship between the sole stockholder and the corporation. The court said (p. 179):

> "The manner in which Herrick business enterprises were carried on shows a complete disregard of corporate organization and identity, not only with regard to the corporations chartered in the same state, but also with regard to corporations chartered in different states. It is not difficult to see Herrick as the prime mover of all the various companies, but the rule is well established that a corporation exists as an entity, and that courts of law will not go beyond the facts of corporate existence in order to examine the real ownership of a corporation."

This was followed by a number of citations emphasizing that the corporation and its shareholders are to be treated as distinct legal persons even where all of the stock is owned by a single shareholder.

The earlier case of *Finn v. George T. Mickle Lumber Co. of Oregon* (C.C.A. 9) 41 F.(2d) 676, and the later case of *Gillis v. Jenkins Petroleum Process Co.* (C.C.A. 9) 84 F.(2d) 74 are to the same effect.

The case of *Haskell v. McClintick-Marshall Co.*

(C.C.A. 9) 289 Fed. 405, is especially apropos in view of its striking similarity to the present case. There the parent organized a subsidiary to construct a building for the parent. Lien claimants asserted liability against the parent on the theory that the subsidiary was merely an agency or instrumentality of the parent. This court said at page 413:

> "The contention that the building company is a mere agency or instrumentality of the bank, and that the lien claimants are entitled to a decree against the bank as well as against the building company, cannot be sustained. It is by no means uncommon for the officers of a bank to form a building company, to furnish quarters for the bank and for other purposes. Nor is it uncommon for the two corporations to have substantially the same officers and stockholders. But mere identity of officers and stockholders is of little moment." (Citing cases)

Turning now to the tax cases, consideration will be limited to decisions of the United States Supreme Court and of the Courts of Appeals for the Ninth and Second Circuits. We refer to decisions of the Second Circuit for the reason that the Second and Ninth Circuits at first took divergent positions on the recognition of the identity of a subsidiary or controlled corporation, the divergence stemming from the same Supreme Court decision, but later the Second Circuit came around to the position of the Ninth Circuit; and for the further reason that appellee has indicated he will depend on Second Circuit decisions to support his position (R. 103).

The Supreme Court case on which the Second and Ninth Circuits diverged was that of *Higgins v. Smith*, 308 U.S. 473, 60 S. Ct. 355, 84 L. ed. 406. The point of the decision that gave rise to the divergence is contained in Mr. Justice Reed's statement for the majority as follows:

> "A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> "On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute."

The case that brought the Second Circuit around to the position of the Ninth Circuit was that of *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S. Ct. 1132, 87 L. ed. 1499. This case will be discussed in detail because it is a landmark case on recognition or non-recognition of separate corporate entity.

In this case the corporation, Moline Properties, had sought to have its separate corporate entity disregarded and to have its gains on sales of its real property taxed to the sole stockholder, the corporation thus taking the position of the appellee in the present case. The Board of Tax Appeals had agreed

with the corporation, but its decision was reversed by the Fifth Circuit. The facts were these:

Thompson, the sole stockholder, formed Moline in 1928 at the suggestion of the mortgagee of certain of his property in order to enable him to use the stock which he received for his equity as security for additional loans. This special purpose for the corporate form was fully accomplished in 1933 at which time the mortgage loan was refinanced and in the language of the Supreme Court "control of petitioner reverted to Mr. Thompson." From then on the corporation form could have been ignored. The corporation, however, continued to hold the property, and sales were made in 1934, 1935 and 1936, the proceeds of which were received by Thompson, the sole stockholder, and deposited in his bank account. It was the gain on the sales in 1935 and 1936 that was involved in this case.

Up until 1933 the business done by the corporation had consisted of the assumption of certain obligations of Thompson, the sole stockholder, the defense of certain condemnation proceedings, and the institution of a suit to remove restrictions imposed on the property by a prior deed, the expenses of which action were paid by Thompson. In 1934 it leased a portion of its property for use as a parking lot for a rental of $1,000.00. It kept no books and maintained no bank account during its existence and owned no other property.

The Board of Tax Appeals held that the gain should be taxed to the individual stockholder on the ground that the corporation was nothing more than an agent for Thompson (45 B.T.A. 647), but the

Court of Appeals reversed, holding that the corporate entity should be recognized (131 F.(2d) 388).

On this situation the Supreme Court said (p. 438):

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." (Citing cases)

After referring to various previous decisions in in which different results were reached under special circumstances which the court recognized as "exceptions but held to lay down no rule for tax purposes" it said (p. 440):

> "When petitioner discharged its mortgages held by the initial creditor, and Thompson came into control in 1933, it was not dissolved, but continued its existence, ready again to serve his business interests. It again mortgaged its property, discharged that new mortgage, sold portions of its property in 1934 and 1935 and filed income tax returns showing these transactions. In 1934 petitioner engaged in an unambiguous business venture of its own—it leased a part of its property as a parking lot, received a substantial rental. The facts, it seems to us, compel the conclusion that the taxpayer had a tax identity separate from its stockholder.
>
> "Petitioner advances what we think is basically the same argument of identity in a differen

> form. It urges that it is a mere agent for its sole stockholder and 'therefore the same tax consequences follow as in the case of any corporate agent or fiduciary.' There was no actual contract of agency nor the usual incidents of an agency relationship. Surely the mere fact of the existence of a corporation with one or several stockholders, regardless of the corporation's business activities, does not make the corporation the agent of its stockholders. Therefore the question of agency or not depends upon the same legal issues as does the question of identity previously discussed."

The *Moline Properties* case and preceding Supreme Court cases and the change of position of the Second Circuit are well discussed in two recent cases decided by the Second Circuit, *National Investors Corporation v. Hoey*, 144 F.(2d) 466, and *Commissioner v. National Carbide Co.*, 167 F.(2d) 304. An analysis of these cases and a comparison of them with the Ninth Circuit case of *Commissioner of Internal Revenue v. Laughton*, 113 F.(2d) 103, will demonstrate that the Second Circuit had broadened the conditions under which the government could disregard corporate entity in tax cases and then had to reverse itself and narrow the conditons to a situation where the corporate form was "unreal or a sham" and only for tax saving, with no real business purpose present, the new position being taken to conform with the Supreme Court's decision in the *Moline Properties* case. On the other hand, the Ninth Circuit in the *Laughton* case, referring to the case of *Higgins v. Smith*, the key case on which the positions of the

Ninth and Second Circuits diverged said (113 F. (2d) p. 104):

> "It is arguable that the Higgins decision means that no matter what the particular 'tax event' may be, if it be more profitable to the tax collector to disregard the intervening corporate entity this must be done. However, it seems to us that if this were the intent of the court it would have said so and not spread its consideration of the cases over many pages of the opinion with such qualifying language as is quoted above.
>
> "We take the opinion to mean that the 'tax event' is not an unreal attempt to use a corporation for a sham transaction, procuring an advantageous tax consequence to the taxpayer, if it may be considered as one primarily for an independent business purpose and not a transfer of assets (here Laughton's services), with a retention of their control, solely to reduce tax liability."

In other words, the *Moline Properties* case vindicated the Ninth Circuit's interpretation of the *Higgins* case as stated in the *Laughton* case, and the Second Circuit reversed itself in the *National Investors* and *National Carbide* cases to put itself in line with the position of the Ninth Circuit.

The *National Investors* case involved these facts: On December 17, 1934, the taxpayer transferred its holdings in three subsidiaries worth $4,660,000 to a fourth subsidiary for all its stock consisting of 10 shares. This was done as preliminary to a plan to unite the taxpayer and its four subsidiaries into one company. This plan was submitted to the stock-

holders on December 20, 1934, but after extended consideration the plan was rejected by the stockholders. The taxpayer then decided to liquidate the fourth subsidiary to which its holdings had been transferred. On December 21, 1935, it turned in one-tenth of the stock for one-tenth of the assets, claiming a loss of $230,000 which was all it could use for tax purposes in 1935. In January, 1936, it completed the liquidation, claiming a further loss, resulting from depreciation in value during 1935 of the securities which were originally transferred and then taken back.

Judge Hand discussed at some length when the corporate form may be disregarded (144 F.(2d) 467 and 468). He first pointed out that originally the Second Circuit, when *Higgins v. Smith* was before it, had assumed that the general rule applied and had allowed the loss:

> "In this we were in error, however, for the Supreme Court held that, although the Treasury might insist upon the separate personality of the corporation when it chose, it might also disregard it, when it chose."

He then pointed out that in *United States v. Morris & Essex R. Co.*, 135 F.(2d) 711, the Second Circuit had interpreted the Supreme Court decision in *Higgins v. Smith* to mean that:

> "The Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat the corporation as a separate person from himself, but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue."

But as to this interpretation, Judge Hand then went on to say in the *National Investors* case:

> "Again we were wrong; we neglected to observe that the corporate 'form' must be 'unreal or a sham' before the Treasury may disregard it; we had taken too literally the concluding language that it was the 'command of income and its benefits which marks the real owner of property'."

This he says, was made evident by the Supreme Court's decision in the *Moline Properties* case, as to which he states:

> "The gloss then put upon *Higgins v. Smith*, supra, was deliberate and is authoritative; It was, that, whatever the purpose of organizing the corporation 'so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity'."

Applying these principles to the case before it, the court held that the fourth subsidiary was properly organized for business purposes for the purpose of putting through the plan of consolidation. However, as soon as that plan was rejected by the stockholders and abandoned, any continued retention of the securities in the subsidiary was not a "business" activity. The court therefore held that the taxpayer was entitled to deduct as a loss any decrease in the value of the securities until the shareholders rejected the plan and for a reasonable time thereafter but that it was not entitled to deduct any depreciation in value after such time when there was

no longer any "business" for the subsidiary to do. That later decreases in value should not be recognized was regarded as the inevitable corollary of the doctrine that the Treasury may disregard transactions with a wholly-owned corporation not engaged in any business activity.

The *National Carbide* case involved these facts:

The parent owned all of the shares of several taxpayer subsidiaries which were formed and used to carry on separate branches of the parent's manufacturing business under a contract designating the subsidiary as agent of the parent. The latter supplied all of the working capital to the subsidiary, provided it with executive management, office accommodations, and other facilities necessary to its operation, furnished and paid for all of the assets held or used by the subsidiary, had the same officers and directors who met only, so far as the subsidiary was concerned, to formally ratify what had already been done by the parent, and maintained control and directed all of the activities of both parent and the subsidiary from one general main office in New York. Here certainly was a situation which allowed for the greatest leeway in disregarding corporate entity, and the court took occasion to review at considerable length the various decisions of the Supreme Court leading up to *Moline Properties, Inc., v. Commissioner*, which it regarded as the final and determinative direction on the subject.

The court (167 F.(2d) 306, 307) observed that in *Moline Properties* the Supreme Court had recog-

nized that there were occasions on which the formal existence of the subsidiary should be disregarded, but that such exceptions were limited to cases where "the corporate form * * * is a sham or unreal" and it concluded further that what the Supreme Court meant by this language was that the subsidiary was a "sham when it was not created or used for some business purpose, but as a screen for another corporation which, or an individual who, was conducting the business." Following this thought the court said that "it is not the presence of an accompanying motive to escape taxation that is ever decisive, but the absence of any motive which brings the corporation within the group of those enterprises which the word ordinarily includes." Proceeding then to the facts of the particular case and the reasons for the parent forming and acting through the subsidiary, it said: "Whatever its reasons, they were business reasons, and the corporations it used were 'corporations' within any interpretation of law. That is enough; it must accept the consequences of that choice, and it is not material that it retained the direction of their affairs down to the minutest detail, that it provided them with their assets, that it stood back of their liabilities and took all of their profits."

The court then went on to reverse the decision of the Tax Court which had set aside income tax deficiencies of the three corporations for the year 1938 on the ground that the income was that of the parent corporation as principal.

In *Rogan v. Starr Piano Company*, 139 F.(2d) 671, the Ninth Circuit reiterated its position as stated

in the *Laughton* case, and the case is especially significant here because of its factual similarity to the instant case. It involved two corporations: one, the Starr Piano Company, the appellee of the case; the other, Gennett, a corporation wholly owned by the Starr Piano Company. The facts as stated by the court were as follows (pp. 672, 673):

> "On February 1, 1921, Clara Howes Mackey leased to appellee for a term of 99 years certain real property in Los Angeles, California. On March 1, 1921, Arthur N. Pelton leased to appellee for a term of 99 years other real property in Los Angeles. In May, 1922, appellee caused Gennett to be organized for the purpose of holding legal title to the leases. On July 17, 1922, appellee transferred the leases to Gennett in exchange for all of Gennett's capital stock. At all times during Gennett's existence appellee owned all of Gennett's outstanding stock. On August 1, 1922, Gennett sub-leased the Mackey and Pelton properties to appellee for a term of 15 years ending July 21, 1937. In 1922 Gennett issued bonds in the sum of $200,000 and, with the proceeds thereof, constructed a building on the Pelton property. On July 1, 1923, appellee and Gennett sub-leased the Pelton property to Bullock's, a California corporation, for a term of 25 years ending June 30, 1948. On May 1, 1924, that term was extended to April 30, 1984. On May 1, 1924, appellee and Gennett sub-leased the Mackey property to Bullock's for a term of 60 years ending April 30, 1984. Gennett's officers and directors were employees of appellee. Gennett had no office separate and apart from appellee, had no assets except the leases, had no bank account and had no employees except its

officers and directors. Its bookkeeping was done by an employee of appellee. Its debts were paid by appellee, and such payments were credited to appellee on Gennett's books. All rentals accruing to Gennett under the sub-leases were collected by a bank as trustee for Gennett and were applied by the bank to the retirement of Gennett's bonds and to the payment of interest thereon and taxes on the leased properties. For the years 1922, 1923 and 1924, appellee and Gennett filed separate income tax returns. For the years 1925 to 1933, inclusive, they filed consolidated returns. In 1934, prior to the merger, appellee transferred certain accounts to Gennett, to be collected in the name of Gennett. Some of the accounts were so collected. The others were transferred back to appellee. Gennett carried on no activities except hereinabove set forth."

The decision goes on to state (p. 674):

"Appellee asks us to disregard the fact that, prior to the merger, appellee and Gennett were separate entities. The trial court thought that this should be done. We do not think so. The following language, used in *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 442, 54 S. Ct 788, 791, 78 L. ed. 1348, is applicable here:

" 'as a general rule a corporation and its stock holders are deemed separate entities and this i true in respect of tax problems. Of course, th rule is subject to the qualification that the sepa rate identity may be disregarded in exceptiona situations where it otherwise would present a obstacle to the due protection or enforcement o public or private rights. But in this case we fin no exceptional situation—nothing taking it ou

> of the general rule. On the contrary, we think it a typical case for the application of that rule'."

The Supreme Court has reiterated the rule of the *Moline Properties* case as recently as March of this year. The *National Carbide* case previously discussed was appealed and the Supreme Court affirmed the decision of the Second Circuit. (See *National Carbide Corporation v. Commissioner*, U.S. Sup. Ct. Law. ed. Advance Opinion, Vol. 93, No. 11, p. 634.)

Chief Justice Vinson wrote the opinion and covered the point as follows (p. 639):

> "The theory upon which the Tax Court expunged the deficiencies apparently was that since the *Southern Pacific Co.* case was not expressly overruled by *Moline Properties*, the 'business purpose' rule laid down in the latter is not absolute, but that the corporate entity may be disregarded (or the corporation treated as an agent of its owner) for tax purposes when the facts of ownership and control of the corporation approximate those presented by the *Southern Pacific* case. The Court of Appeals disagreed. It held that under our decisions, when a corporation carries on busines activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise. The court concluded that 'Even though *Southern Pacific Co. v. Lowe*, *supra*, set up a different test, we regard it as pro tanto no longer controlling.'
>
> "The result reached by the Court of Appeals is clearly required by our later decisions."

We submit that the District Court was in error in

deciding the instant case on the basis that the separate identity of the Occident Trust Company should be ignored.

II. Basis for Loss on the 1945 Sale.

The District Court decided this case on the preliminary point of whether or not the separate identity of the Occident Trust Company should be recognized (R. 191, 220). It did not get to the question of basis for determining loss on the 1945 sale or the question of the appellant's invested capital credit for excess profits tax computation for the years 1941 through 1945, if the separate identity of the Occident Trust Company was to be respected. It is appellant's position that for gain or loss purposes its cost in Lots (1) and (2) and the building, before additions to and depreciation of the building, was the fair market value of the stock of the Occident Trust Company surrendered when the land and building were transferred to it, that fair market value in turn being measured by the fair market value of the assets transferred. The fair market value of the land, as stipulated, was $224,322.00, and the building $270,751.38 at the time of the transfer. On this point the cases have uniformly held that where stock is turned over for property, cost is the value of the stock which, in turn, if closely held, is equivalent to the fair market value of the property received. In the case of *Reliance Investment Co.*, 22 B.T.A. 1287, the Board said at page 1289:

> "The petitioner in 1925, 1926 and 1927, sold property which it had in 1914 acquired in exchange for all its stock. The respondent computed the gain from these sales upon the basis of the

> cost to petitioner in 1914. The cost was taken to be the value of petitioner's stock when issued for the property, and such value was taken as the equivalent of the stipulated value of the property received. This is the long accepted way of determining such cost. *William Ziegler, Jr.*, 1 B.T.A. 186; *Mead Realty Co.*, 21 B.T.A. 1062."

In the case of *William Ziegler, Jr.*, 1 B.T.A. 186, at page 192, the Board said:

> "The usual method of appraising stock issued for property where there is no evidence of the market value of the stock is to say that the stock is deemed equivalent in value to the property for which it was issued, and by determining the value of the property, one can determine the value of the stock."

In presenting the statutory provisions for determining gain or loss, brief reference will be made to the sections covering tax free liquidation of a subsidiary, even though they are not applicable in this case, first of all because the appellee has indicated he will assert their applicability and secondly because some reference to them will make it easier for this court to follow discussion of these provisions in cases hereinafter cited and discussed.

The statutory provisions for determining the amount of gain or loss are found in Section 111, I.R.C., those prescribing the extent to which gain or loss shall be recognized are in Section 112, and those for determining the basis of property sold or exchanged are in Section 113. Section 111 provides in part as follows:

> "(a) The gain from the sale or other disposi-

> tion of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."

Section 113(b) provides in part as follows:

> "(b) Adjusted Basis—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided." (There follows provision for depreciation, depletion, etc.)

Section 113(a) provides in part as follows:

> "(a) Basis (Unadjusted) of Property—The basis of property shall be the cost of such property; except that * * *."

This is followed by twenty-two exceptions to this stated rule, none of which are applicable to basis for determining *loss* on property acquired before March 1, 1913.

Section 113(a) (14) provides an exception in basis for determining *gain* on property acquired before March 1, 1913, but it is silent as to basis for determining *loss* on property acquired before March 1, 1913, and the Commissioner's regulations (Regulations 111, sec. 29.113(a)(14)-1) explicitly recognize that fact.

The provisions of the Internal Revenue Code covering the tax free liquidation of a subsidiary ar

Section 113(a) (6), Section 113(a) (15) and Section 112(b) (6).

Section 113(a) (6) provides that if property was acquired after February 28, 1913, upon an exchange described in Section 112(b) to (e), the basis, *except as provided in paragraphs* (15), (17) *or* (18) *of this sub-section*, of the transferee shall be the same as that of the transferor.

Section 113(a) (15), *one of the exceptions to Section* 113(a) (6) *above*, provides, with certain exceptions of no importance here, that where property is received by a corporation in complete liquidation of another corporation within the meaning of Section 112(b) (6), then the basis shall be the same as in the hands of the transferor.

Section 112(b) (6) provides that: "No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation."

The provisions of 112(b) (6) under which no gain or loss is recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation and 113(a) (15) that the basis of the transferee is that of the transferor first appeared in the Revenue Act of 1936 and that Act by its own terms applied only to taxable years beginning after December 31, 1935. (Section 1003 of the Revenue Act of 1936 provided: "Except as otherwise provided, this Act shall take effect upon its enactment. Approved, June 22, 1936, 9 P.M.")

This was pointed out in *Commissioner v. Stimson Mill Co.* (C.C.A. 9) 137 F.(2d) 286.

Prior to the Revenue Act of 1936 the liquidation of a subsidiary was a transaction on which gain or loss was recognized the same as in any other case of liquidation and the basis of the parent in the assets received was cost; such cost being the fair market value of the assets received from the subsidiary in exchange for surrender of the stock of the subsidiary at the time of liquidation. (See Merten's Law of Federal Income Taxation, Vol. 1, Section 9.86, p. 559).

The following cases cover the situation from the time the income tax laws first went into effect, March 1, 1913, to the effective date of the Revenue Act of 1936. They are presented somewhat in detail not only to show that the liquidation of a subsidiary prior to 1936 was a taxable transaction giving rise to a new basis, but also to show that the courts have treated similar transactions (of the kind involved in the instant case) as appellant contends the 1906 transaction should be treated in the instant case. This is followed by a presentation of cases showing that transactions of this kind occurring prior to March 1, 1913 are afforded the same treatment as those occurring between 1913 and 1936.

Frelmort Realty Corporation, 29 B.T.A. 181, involved a 1925 transfer of assets from a subsidiary to the parent. The Board said at pages 189 and 190:

> "In the cases we have here, the evidence leaves no doubt that it was the intent of the parties interested in Brown-Rochester to wind up its business. It had been formed for a particular

purpose—to hold title to certain real estate—and upon disposition of the property there was obviously no further need for the corporation to exist as a separate entity. Consequently those in control decided to liquidate it, and upon distribution of its assets to petitioner the liquidation was an accomplished fact. The fact that petitioner continued to hold the stock of Brown-Rochester and the latter has not been formally dissolved is no obstacle to the transfer being a distribution in liquidation.

* * * * * * * * * * *

"It is well settled that the transfer, in liquidation, of a subsidiary's assets to the parent may result in gain or loss to the parent. *Riggs Natl. Bank*, 17 B.T.A. 615, affd. 57 F.(2d) 980; *Canal-Commercial Natl. Bank*, 22 B.T.A. 541, affd. 63 F.(2d) 619. We hold that petitioner acquired the assets of Brown-Rochester in liquidation, and the tax should be computed accordingly."

France Co. v. Commissioner (C.C.A. 6) 88 F.(2d) 917, involved a 1929 liquidation. That court said at page 918:

"It cannot be doubted that these transactions effected a complete liquidation of Bascom. Such was their purpose. Therefore the assets which were distributed to the petitioner, the sole stockholder, must be treated in full payment for the 400 shares of Bascom stock which were delivered in exchange therefor."

Pierce Oil Corporation, 32 B.T.A. 403, involved a 1918 liquidation. The Board said at page 431:

"When, however, Pierce Fordyce was, in 1918, completely liquidated, albeit not formally dis-

solved, and Pierce Oil, as its shareholder, received its assets in lieu of its certificates, this gave rise to gain or loss measured by the difference between the investment in the certificates and the actual value of the liquidated assets." (Citing cases)

Vonnegnt Hardware Co., 28 B.T.A. 784, involved a 1925 liquidation. The Board said at page 786 and 787:

"It seems clear that this transaction—the purchase of the stock of the Lilly Co., immediately followed by liquidation and distribution of the corporate assets—is one upon which gain or loss is to be recognized. * * *

"While it is true that the Lilly Co. was not immediately dissolved, that fact did not prevent its liquidation, for after its stock was purchased by petitioner, its regular business terminated and its existence was continued for the restricted necessity of proceedings for the collection of its outstanding accounts. *Fred T. Wood*, 27 B.T.A. 162, and cases there cited."

American Printing Co., 27 B.T.A 1270, involved a 1917 liquidation. The Board said at page 1279:

"Under the transactions described in our findings of fact, the American Printing Company acquired all the assets of its subsidiary the Fall River Company, on December 31, 1917, in liquidation and thereby realized a profit on the disposition of its stock. * * * The cost to the American Printing Company of the assets thus acquired from the Fall River Company, therefore, was their fair market value as of December 31, 1917. This cost, then, became the basis for determining gain or loss on the sale of such assets, and the basis for

computing depreciation and valuing the opening inventory for 1918."

Does the fact that the exchange of stock for property in the instant case took place prior to March 1, 1913, the effective date of the income tax, make any difference as far as basis for gain or loss is concerned? The cases hold not.

Regal Shoe Co., 1 B.T.A. 896, involved a Maine corporation organized on January 17, 1907. On January 18, 1907, it issued common stock of $2,499,000 and preferred stock of $1,000,000 in exchange for the entire outstanding capital stock of three predecessor corporations. It had previously issued $1000 of stock for $1000 cash paid in by the incorporators. On January 31, 1907, thirteen days later, the three predecessors were merged with the Regal Shoe Co., all of their assets being turned into the Regal Shoe Co., that company surrendering all of the capital stock of such corporations for cancellation.

The issue involved taxpayer's invested capital under section 326 of the Revenue Act of 1918, and the case is pertinent here because of principles that were promulgated in resolving that issue. The Government argued that the transaction should be considered as a single transaction of the Regal Shoe Co., exchanging its stock for assets of the three predecessor corporations instead of considering that Regal stock was exchanged for the predecessor's stock and then thirteen days later Regal received the assets on liquidation of the predecessors.

The Board held that the invested capital was properly $3,500,000, stating (p. 900):

"It is undoubtedly true, as appears from the resolution of January 31, 1907, that the taxpayer at all times intended to acquire the business and assets of the three predecessor corporations, but the fact is that before it acquired these assets it had acquired the stock which the statute characterizes as tangible property, and the assets were acquired not for the stock of the taxpayer company but in liquidation of the stock of the other three corporations which it held. The one transaction was just as important and legally real as the other. During a 13-day period the ownership of the stock and of the assets was in different legal hands, and the practical and legal incidents of such ownership were different. *United States v. Phellis*, 257 U.S. 156. This is clear from the fact that at the time of the liquidation the assets received were worth more than the price previously paid for the stock. If the provisions of the 1918 Act had been in effect in 1907, no one would dispute the right of the Government to impose a tax upon the gain represented by the difference between the price paid and the amount received in liquidation, namely, the increase in actual value of the assets received in liquidation over the actual value of the stocks at the time the taxpayer acquired them for its own stock; and this would be true irrespective of the length of time which elapsed between acquisition of the stock and the subsequent liquidation thereof and receipt of the assets."

Otto H. Kahn et al. v. Commissioner, 27 B.T.A. 244, involved these facts: The petitioners in the case acquired certain bonds in 1904 at a cost of $143,155.28. In 1912 on a reorganization they exchanged the bonds for other bonds having a fair market value of some-

thing less than the original cost of $143,155.28. By March 1, 1913, the bonds had further declined in value. They argued that the bonds received in the 1912 exchange should have the same basis as the cost of the bonds exchanged, $143,155.28.

The Board held that the bonds took a new basis on the 1912 exchange pointing out that if the exchange had taken place after February 28, 1913 the 1904 basis would have carried through.

The case of *St. Louis Trust Co., Executor of the Will of Edwin Mallinckrodt, Sr., Petitioner, v. Commissioner*, 14 B.T.A. 323, involved this situation. Prior to March 1902, Edward Mallinckrodt, decedent, owned 500 shares of stock of the Union Trust Co. which cost him $214.8713 per share. On March 1, 1902, the assets of the Union Trust Co. were taken over by the St. Louis Union Trust Co. On that date decedent exchanged his 500 shares of stock in the Union Trust Co. for 500 shares of stock in the St. Louis Union Trust Co. and $92.00 cash per share. At the time of the exchange, the market value of the Union Trust Co. stock was $446 per share. In 1921 petitioner sold the St. Louis Union Trust Co. stock for $200.50 per share. The Board held that the petitioner sustained a loss in 1921 using as cost the March 1, 1902 market value of $446 per share for the 500 shares of stock of Union Trust Co. exchanged, reduced by $46,000.00 cash received at $92.00 per share.

It is apparent under these decisions that in the instant case appellant is entitled to claim a loss on the sale of the land and building in 1945 measured by

the difference between their fair market value on February 21, 1906, less depreciation to the date of sale on the building, and the selling price in 1945.

III. Basis for Excess Profits Tax Credit.

The final question in this case is how appellant's invested capital credit under the excess profits tax law is affected by the 1906 liquidation of the Occident Trust Company. We believe that the determination of the gain or loss issue also controls this excess profits tax issue. The statute prescribes an extremely technical formula for determining invested capital credit. The first step is to reach back to the organization of the corporation and build up so-called equity invested capital in the following manner:

> First: all the money and property that has ever been paid into the corporation for stock, as paid in surplus, or as a contribution to capital is aggregated—regardless of what may have happened to the money or property after its acquisition.
>
> Second: the accumulated earnings and profits from the inception of the company up to the beginning of taxable year are added in. Any deficit, however, is disregarded.
>
> Third: the sum of the first two items is reduced by all the distributions that have been made to stockholders out of other than earnings and profits.
>
> These first three computations produce what is known as "equity invested capital."

In the instant case the Seattle Hardware Company

had a realized profit on the 1906 liquidation of the Occident Trust Company of the difference between the cost of the building and lots to the Occident Trust Company and the fair market value of the building and lots at the time of the liquidation (the difference between $244,000 and $270,751.38 for the building and the difference between $60,000 and $224,322 for the lots). This profit constituted an addition to accumulated earnings and profits, or an addition to paid in surplus, going into equity invested capital. As has been shown before and will be shown hereafter, in the transfer involved here, this profit is just as real and affects equity invested capital just as much as it would have in a transfer subjected to tax. The Seattle Hardware Company is entitled to the adjustment in equity invested capital.

The following cases involved issuance of stock for property either prior to the income tax law or under transactions that were not tax deferred under Sections 112 and 113, and their underlying principles are applicable to the excess profits tax issue herein.

The first case is that of the *The Maltine Co., Petitioner v. Commissioner*, 5 T.C. 1265. The Commissioner acquiesced in the decision in 1946; 1 C.B.3. The case involved the following facts: On February 6, 1878, a corporation known as The Maltine Manufacturing Co., was organized with a capitalization of 1,000 shares of a par value of $100 each or a total capitalization of $100,000. All of these shares were issued and outstanding on January 8, 1898, being held by four individual stockholders. In December

of 1897 a new corporation called The Maltine Co. was organized, with a capitalization of 10,000 shares of a par value of $100 each, or a total capitalization of $1,000,000. On January 8, 1898, the stock of The Maltine Co. was issued and thereafter held by the same four individual stockholders in the same proportionate interest as that of The Maltine Manufacturing Co. The stock was issued in accordance with a contract dated January 8, 1898 between the two corporations, whereby The Maltine Manufacturing Co. agreed to turn over all its assets to The Maltine Co., issuing all its stock to the stockholders of The Maltine Manufacturing Co. in their proportionate interests. The Tax Court said (pages 1271 and 1272):

> "There seems to be no serious doubt that if the transaction had occurred in later years it would have qualified as a tax-free reorganization, and in that case petitioner would be required to use its transferor's base for the purpose under discussion. The immediate question here, then, is whether the fact that the transaction occurred in 1898 leads to a different result.
>
> "Section 718 (a) (2) of the code provides that property acquired for stock shall be included in the computation of equity invested capital at an amount equal to its basis (unadjusted) for determining loss upon a sale or exchange.
>
> "Section 113 (a) of the code provides: 'Basis (unadjusted) of Property.—The basis of property shall be the cost of such property; except that * * *.'

"There follow twenty-two exceptions to this basic rule, of which none is claimed by respondent to be applicable to the present situation. Consequently, we conclude that the petitioner's basis of the property involved here for determining loss upon a sale or exchange is cost."

The court then went on to examine the exceptions somewhat in detail and said:

"These exemptions, which do not apply here, are examined because they indicate the degree of precision with which the statute provides for the varying situations for which Congress intended to make special exceptions. The inevitable conclusion is that it meant exactly what it said when it said that the basis, except for the several special situations thereafter specifically set forth, should be cost. To hold petitioner's basis for determining loss to be other than cost would be to create another exception, which we conceive to be properly the task of Congress if it is to be done.

"There now arises the question of the valuation of the assets acquired by petitioner as outlined above."

The court went on to find that the value of the tangible property of The Maltine Co., acquired in the contract of January 8, 1898, was \$134,926.34 and the value of the good will or intangibles, was \$866,000.00 and the Maltine Company was entitled to use the total of the two, or \$1,000,926.34 in computing equity invested capital for excess profits tax purposes.

The case of *Florida Machine & Foundry Co. v.*

Fahs, 73 F.Supp. 379, (aff'd. C.C.A.-5 168 F.(2d) 957) involved the following facts: One Franklin G. Russell acquired a piece of land in 1912 for $25,000, and used it in a sole proprietorship business called Florida Machine Works. On July 16, 1924, Mr. Russell, his son, and another employee, organized a corporation known as the Florida Machine & Foundry Company. Mr. Russell turned in the land and the other assets of the sole proprietorship in consideration of the new corporation, issuing one-half of its stock to him and approximately one half to his son, three qualifying shares being held by other people.

The corporation sold an unneeded portion of the land in 1941 and the issue in the case was the cost basis of that portion for gain or loss on the sale and the cost basis of the remainder for determining equity invested capital for 1941 and 1942. The government argued that the transfer to the corporation in 1924 was tax free and that Russell's basis carried over into the hands of the corporation.

The court examined the tax free sections in detail and held that the basis for both gain or loss and equity invested capital purposes was the fair market value at the time the property was transferred to the corporation even though the 1924 transfer had not been treated as a taxable transfer by Russell. Russell, in getting 50% of the stock of the corporation, did not have the required 80% to make the transfer tax free.

The case of *Independent Oil Co.* 6 T.C. 194 (the Commissioner acquiesced in the decision in 1946; 1 C.B. 3) decided February 6, 1946, involved the fol

lowing facts: The petitioner in 1930 acquired the assets of a predecessor of the same name. In its excess profits tax return for 1940 in its computation of equity invested capital under the invested capital method, petitioner included property paid in for stock at cost, *i.e.*, the fair market value of the petitioner's stock paid for the old company's property, namely, $3,156,558.67. The Government argued that petitioner should not have included property paid in for stock at cost but rather at the basis of the property to the petitioner's transferor.

Here, too, the Tax Court found that the necessary control did not remain in the transferor and decided the case for the petitioner after carefully examining the tax free reorganization sections of the Internal Revenue Code.

The case of *Henderson Overland Company*, 4 B. T.A. 1088 involved a determination of invested capital credit for income and profits taxes for 1919 and 1920. In August of 1916 the petitioner issued stock for a piece of real estate. The Government argued that petitioner's cost in the real estate for invested capital purposes was the cost of the transferor, the above transaction being a tax free exchange of the lot for stock under section 331 of the Revenue Act of 1918. The Board held that since the exchange took place prior to March 3, 1917 it was not covered by the tax free provisions. It held that since the cash value of the lot exceeded the par value of the stock issued therefor, the excess was to be treated as paid in surplus for purposes of computing invested capital.

IV. Conclusion

Appellant submits that the Occident Trust Company was a complete entity with a business purpose and business activity, and should be so recognized, and under applicable statutes and decisions appellant received the assets of the Occident Trust Company in liquidation thereof on February 21, 1906, and appellant's basis in the assets for gain or loss and equity invested capital is their fair market value on February 21, 1906, less depreciation on the improvements to the date of the sale in 1945.

Respectfully submitted,

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